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The Impact of the Restructuring of the Oil Sector in Saudi Arabia

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May 28, 2015

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By Jean-François Seznec

Executive Summary

Saudi Arabia is the largest exporter of oil in the world, one of only three producers able to sustain production around 10 million barrels per day (b/d) and the only oil producer that can increase production by 2 million b/d rapidly.[1] Accordingly, and in great part based on this ability to flood or starve oil markets, the kingdom has had a strong influence on the price of oil for the past 40 years. It is in this sense that any change in management structure and overall control of the energy industry in Saudi Arabia is not only closely followed, but also affects prices of energy worldwide.

Since King Salman bin Abdulaziz took the throne after the death of his half brother Abdullah in January, there have been many important changes in government and economic structure, most notably in the oil sector. While many of the bureaucratic changes have been widely assessed, it is the changes in the oil sector that have puzzled even seasoned observers, rendering the deciphering of oil policy in the kingdom even more difficult than the historical norm. The main changes, as they relate to oil were:

- The Ministry of Petroleum and Mineral Resources has reportedly been "separated" from Saudi Aramco. While the long-term consequences of this change are still unclear, in the short term the main effect will be that Minister of Petroleum Ali al-Naimi is no longer chairman of Saudi Aramco. More importantly it means that Saudi Aramco is now under the supervision of the Supreme Council of the Saudi Aramco Oil Company (SCSA), which is chaired by newly named Deputy Crown Prince and Minister of Defense Mohamed bin Salman (MbS) – the king's son.

- The CEO of Saudi Aramco, Khalid al-Falih, was relieved of his position at Saudi Aramco and promoted to minister of health. Nonetheless, he remains a part of Saudi Aramco through his promotion to chairman of Saudi Aramco and his expected appointment as a member of the SCSA.

1 The other two countries are the United States and Russia. All three can claim to be the largest producers depending on whether production is counted with or without natural gas liquids (NGLs), or when the accounting is reported. It seems that Russia with sustained, but declining production of 10.2 million b/d could be the main crude oil producer, while the United States produces only 9.3 million b/d of crude but also 3 million b/d of NGLs. Saudi Arabia produces 9.6 million b/d (Feb. 2015) and over 1 million b/d of NGLs (est.). Figures, except NGLs for Saudi Arabia, from MEES, April 24, 2015, p13 and 27, and from Oil and Gas Journal May 11, 2015 p. 32-33

- The SCSA has 10 members – five from the board of Saudi Aramco and five others have not yet been announced, except for the new secretary general of the SCSA, Majid Al-Moneef, former Saudi representative to OPEC and former national representative of Saudi Arabia at OPEC.[2]

- The Supreme Council for Petroleum and Mineral Resources, which was headed by the king and placed oil policy under the aegis of the major princes, has been absorbed into the Council of Economic Development, which regroups 13 inter-ministerial councils and commissions into a single administrative council linked to the Council of Ministers and presided over by MbS.

This commentary will try to unpack what the changes mean to the markets today and what further changes could be expected.

The Changes Relating to Energy in Saudi Arabia

The Ministry of Petroleum and Minerals

The main change in the Ministry of Petroleum and Mineral Resources (MoPM) appears to be that the minister of the MoPM is no longer the chairman of Saudi Aramco. The MoPM minister had been chairman of Saudi Aramco since 1983, under two previous oil ministers, allowing for the chairmanship to historically act as the MoPM's power base. Yet, with recent changes, this trend has been broken and Khalid al-Falih, the former CEO of Saudi Aramco, has been named the chairman of OPEC's largest oil company.

Falih has also been named minister of health. The position has been fraught with many difficulties and has seen a large turnover of ministers, who were all expected to bring efficiency to the Ministry of Health, yet were unsuccessful. In this sense Falih will attempt to improve the ministry at a time when the royal leadership feels pressure to show the Saudi citizenry that they are able to provide fundamental social services, such as healthcare, efficiently to the population. Hence, Falih, who is considered by many to be one of the best managers in Saudi Arabia, is now tasked with directing Saudi Aramco at a time of relatively low oil prices, as well as reorganizing a health system widely perceived as dysfunctional.

Minister of Petroleum and Mineral Resources Ali al-Naimi has been perceived as the main policy guru for oil in the kingdom. He has held the position for the past 20 years, and prior to that was CEO of Saudi Aramco for 12 years. As minister he directed the oil industry of the kingdom, largely oversaw the Supreme Petroleum Council on behalf of the kings, imposed his will on OPEC, and managed, with some success, to keep oil prices relatively stable, limiting the spikes and troughs inherent to the industry.

Presently the crude oil market is over supplied because China's expected growth has slowed to 7 percent (though still a remarkable level) while U.S. production is increasing. Total U.S. production of crude is now at 9.38 million b/d and imports are down to 9.976 million b/d. The United States is also exporting substantial volumes of refined products, resulting in a decline in the United States' total net imports to only 5.993 million b/d, down from over 14 million b/d in 2006.[3] This large increase in U.S.

2 Kapsarc.org, page on governance-international advisory board-Al Moneef bio. Accessed on May 9, 2015

3 Oil and Gas Journal, May 11, 2015, p. 32-33

production, coupled with the consequential declining imports, has created a glut in the market, while there is little hope that China will take on all the excess volume available from both OPEC and non-OPEC producers, mainly Russia. Yet, regardless of the oil glut, in the past few months, by maintaining Saudi production around 10 million b/d in a market that has been flush with crude, Naimi has enacted policy that prioritizes the protection of the kingdom's market share over oil profits. Hence, when Naimi announced in December 2014 that Saudi Arabia would maintain production at over 9 million b/d, prices went from $110 per barrel to as low as $46 per barrel. While prices have recovered substantially to about $67 per barrel, even at this improved price, the kingdom will incur a budget deficit in 2015 of close to $39 billion. Moreover, this deficit does not include undisclosed military expenses, which will probably amount to over $80 billion, resulting in a total deficit to the kingdom of about $120 billion in 2015.

It is very likely that the major world producers will be impacted even more than Saudi Arabia by the low prices of the first half of 2015. The main producers affected are the shale oil producers of the United States, who may have to curtail their drilling and pumping. However, with strongly declining costs of fracking due to better technology, the shale oil producers will still find it advantageous to produce at $67 per barrel, seeing as their costs are now closer to $35 per barrel.

With this in mind, the main producer impacted by Saudi Arabia's large production is Russia. One of the clearest indicators of this aim has been the word of Naimi himself. In a December 2014 interview, Naimi noted that, in his opinion, it is illogical for a high efficiency producer like Saudi Arabia to lower its production to protect prices when the largest benefactors of high prices have been inefficient, high cost producers such as Russia, who "need continuous investment in new wells and... cannot shut in old wells, because if they do, they will not come back up...[which] is the opposite of fields in the Gulf, which are still young."[4] Aside from Russia's higher production costs, the Russians are much more sensitive to price declines than Saudi Arabia due to a smaller cash reserve cushion. Russia's cash reserves are about $356 billion,[5] while the Saudis' are $730 billion, with the ability to raise another $250 billion from internal institutions.[6] It is therefore likely that it is Russia, which has been deemed by Naimi to have many inefficient and marginal wells, that is the most vulnerable to the Saudi effort to maintain market share. Nonetheless, Saudi Arabia has been talking extensively with Russia to suggest mutual cooperation in bringing the market back up to a more sustainable level.

It is not clear what the Saudi target price is, if any, but in light of previous statements and experience, it should be high enough to cover most of the Saudi budget and low enough not to smother the world's economy. Hence, a suitable target price could be between $80 per barrel, which would leave Saudi Arabia with a manageable deficit of $60 billion or 8 percent of GDP, and $100 per barrel, for no deficit.[7]

The SCSA

The new Supreme Council of Saudi Aramco (SCSA), which is now in charge of Saudi Aramco, is not as new or as revolutionary as it may initially appear. Of course, it comes on the heels of the cancellation of the Supreme Petroleum Council (SPC), which being merged into the Council of Economic and

4 "MEES Interview With Ali Naimi: 'OPEC Will Never Plan To Cut'" MEES, Volume 57, Issue 51/52, Dec 22, 2014

5 IMF Calculations, Accessed at: http://www.imf.org/external/np/sta/ir/IRProcessWeb/data/rus/eng/currus.htm

6 Compiled from SAMA Monthly Statistical Bulletin, December 2014 Table 8A and 10, 11A

7 Based on a GDP in 2014 of $745 billion

Development Affairs under the direction of MbS has caused broad and sustained speculation as to the degree of royal rule over oil policy. However, prior to the establishment of the SPC there had been a supervisory committee of Saudi Aramco also called SCSA. The SPC replaced this committee in order to provide the royal family with more input into the management of oil policy. Without being privy to the internal policies of Saudi Arabia, one could surmise that the senior princes at the time wanted more say in how much, and by what means, oil would be produced. However, very rapidly the technocrats on the SPC, principally Naimi, were able to take back the management of oil policy, mainly because its production is subject to many financial and technical variables for which internal politics could not readily account. Hence, under the SPC, the MoPM and Saudi Aramco remained mostly independent from the influence of senior princes. Looking at the makeup of the new SCSA, it seems likely that this limited royal intrusion on oil policy will continue. The new SCSA's 10 members have not yet been officially announced. However, it seems that five will come from the board of Saudi Aramco, thus including Falih, the chairman, and the new CEO of Saudi Aramco, the other three members from the Saudi Aramco side will be non-royal as the entire board is composed of commoner technocrats. Among the other five, the new secretary general of SCSA, Majid Al-Moneef, will be one, Naimi is likely to be another (maybe as a member of the Saudi Aramco board), and of course MbS, who is the only royal thus far on the council, will be another. In this sense, it seems that the SCSA in fact will be less under the control of the royal family than the SPC had been.

Many observers have speculated that the removal of Naimi from the chairmanship of Saudi Aramco would mean that he would probably retire and be replaced by Prince Abdulaziz bin Salman (AAbS), another of the king's sons, who had been at the MoPM for many years as number two to Naimi. AAbS was promoted to deputy minister of the MoPM. However, now that the chairmanship of Saudi Aramco is removed from the minister and that Saudi Aramco has been disassociated from the ministry, it means that even if Naimi retires, and AAbS becomes minister, he will have no role at Saudi Aramco and minimal role in defining oil policy, although he may get a seat on the SCSA.

The Changes and Policy

While the new energy policy appears substantive, in reality it may not bring any changes to the oil policy of the kingdom. The new structure mainly recognizes the importance of the technocrats and engineers in managing the oil and natural gas endowment of the country. In fact it seems to limit the role of the royal family in the management of these assets. Accordingly, the main difference with the previous structures, which had given prominence to Naimi, is that the oil and natural gas industry of Saudi Arabia has been streamlined, with one less layer involved in the policy making and management of the national oil company.

Undoubtedly, the removal of Naimi and the MoPM from controlling Saudi Aramco is a major change. It means that Naimi's policy of risking low oil prices to force a change of policy by non-OPEC members, mainly Russia, may not be continued as aggressively as it has been in the past few months. Yet does it mean that Saudi Arabia's new oil leadership will cut production? Most likely it does not. Not only have prices already been inching up, but a semi-independent Saudi Aramco that is still controlled by technocrats will not stray far from Naimi's views.

Moreover, the new Saudi oil structure will not change many of the foundational factors driving the kingdom's oil policy. It will not change the cash reserves of Saudi Arabia, nor will it change those of Russia. It will not influence U.S. shale producers to produce less, especially at a time when their costs are also declining. Thus it is likely that slowly and quietly, the Saudis and Russians will find it accommodating to decrease production marginally and see prices increase. In this sense, if the classical economics of oil as an inelastic commodity are upheld, Saudi Arabia and Russia cutting supplies by only 5 percent could cause prices to go up by as much as 20 or 30 percent. Nonetheless, the key to this will be to do it slowly and quietly over time as not to spook the markets.

The Streamlining of the Saudi Energy Empire

Another important consequence of the kingdom's reorganization of the oil industry is what amounts to a breakdown of the MoPM from being a ministry in charge of oil and minerals to merely a Ministry of Minerals. This, in and of itself, could also lead to a major reorganization of the kingdom's downstream energy industry, a cut in subsidies, and an increase in the price of natural gas.

Falih, the new chairman of Saudi Aramco was well regarded for having diversified it from being merely the largest oil supplier in the world to becoming a large chemical company. Saudi Aramco now controls PetroRabigh a large refinery and chemical venture with Sumitomo. It also controls SADARA, a joint venture with Dow Chemical that is slated to be the largest chemical venture in the world. This project of $20 billion is being completed this year and will produce massive amounts of advanced chemicals for both export and local transformation by smaller companies.[8] Saudi Aramco is also investing in the growth of its refining capability. Its capacity is now at 2.6 million b/d and will increase to 3.3 million b/d as the new joint venture with Sinopec in Yanbu ramps up this year and the joint venture with SABIC in Jizan comes into operation.

As mentioned, Falih has now been named minister of health to reorganize the MoH much like he did Saudi Aramco. When this is coupled together with the streamlining of the oil and natural gas industries, it could indicate that Saudi leadership, mainly MbS who is in charge of the economy, is seeking to make the state-run industrial sector more efficient. These changes, when considered in light of other changes that, while not related to oil, were still under the aegis of MbS, may point to a massive effort by MbS to bring efficiency and professionalism to the system.[9] Moreover, a common thread to all the changes is the speed with which they are taking place. In this sense, there is clearly a major sense of urgency in the kingdom to create jobs and ensure that the economy runs efficiently.

This sense of urgency and need for efficiency may translate into further important changes for the state owned enterprises, if only to trigger more interaction with the private sector and ultimately create more jobs. In the spirit of improving efficiency, one could perhaps expect Saudi Aramco's activities to focus not only on crude oil and refining, but increasingly in chemicals as well. Saudi Aramco is already in control of PetroRabigh, a very large Public Private Partnership (PPP) in joint venture with Sumitomo, and where the original $10 billion project is presently being doubled in size. Moreover, as a PPP, 30 percent of the project's ownership is in the hands of the public at large. SADARA is another joint venture of Saudi Aramco. In partnership with Dow Chemical, this $20 billion venture is expected to start production shortly. It is also expected to float 35 percent of the capital to the public through

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8 The advanced chemicals to be produced by this joint venture mainly consist of amines glycol ethers, isocyanates, polyols, and performance plastics

9 MbS as minister of defense, previously as deputy to his father, replaced Prince Khalid bin Sultan and chief of the military with a general from outside the royal family. Later, they named Mohammed al-Madi, who steered SABIC into becoming the number two chemical company in the world, to manage military investments

shares on the Tadawul exchange in Riyadh. Additionally, SADARA will be expected to help smaller firms develop the capability to take some of its productions and transform them into marketable products for both domestic use and export. The salient theme throughout all these endeavors is the concerted effort to create as many good downstream manufacturing jobs for Saudis.

By viewing the institutional and structural changes in the oil sector as an attempt to streamline production and decision making, it becomes increasingly plausible to imagine the same restructuring being extended into other downstream industries, such as the fertilizer industry. SABIC, which has become the second largest chemical company in the world, is now divided into three divisions. The fertilizer division, which makes methanol, ammonia, and urea, exports worldwide. The division is in a joint venture with Maaden, the mining company, which extracts phosphate rock and works with SABIC to make DAP, a high value added fertilizer. The Maaden-SAIC joint venture is called Maaden Phosphate Company (MPC). Maaden is also in joint venture with Mosaic of the United States to start a similar production using phosphate from another mine. It would make some sense to have all the fertilizers of the kingdom manufactured and marketed worldwide by the same company. SABIC also runs a large steel plant, which could fit nicely in terms of research and marketing with the 850,000 tons per year aluminum plant presently run by Maaden in joint venture with Alcoa. In this sense, it is plausible to expect a consolidation of the fertilizer industry under one company, perhaps under Maaden. Similarly, one could perhaps expect SABIC's chemical activities to be regrouped with those of Saudi Aramco, to have only one fully integrated chemical giant in the kingdom. This chemical giant would be getting its main raw materials – natural gas and naphtha – from Saudi Aramco. This would allow for streamlining under the Saudi Aramco umbrella, a bit like ExxonMobil runs a huge chemical division, or entirely under SABIC's as an efficient chemical company.

In this line of reasoning, the streamlining of state enterprises could grow to encompass a Saudi Aramco to resemble ExxonMobil with large oil, natural gas, refining, and chemical divisions; a Maaden focused on mining operations; a new metals company regrouping steel and aluminum; and a new fertilizer company centralizing the fertilizer divisions of Maaden and SABIC. At a time when the Saudi leadership is increasingly looking to economically diversify, while broadening and deepening its private investment, these newly streamlined companies would easily appeal to investors in the stock market. In other words, such rationalization of the industrial activities could lead to a sort of privatization, which in turn could lead to more investments by the private sectors in industry, ultimately leading to the creation of more employment opportunities for Saudi citizens.

Conclusion

The sense of urgency shown by the rapid reorganizations at the top of the country and the shuffling of the main technocratic jobs means that the new generations of Saudis, royals and commoners alike, have taken over the levers of command. The kingdom will continue to work at establishing its credibility in the economic sector through streamlined industries that will increasingly appeal to investment and provide domestic employment. Yet, with these objectives in mind, it will remain important for Saudi Arabia to continue the oil policies of Naimi in order to regain control of the oil markets. Fittingly, the changes to the sector's structure, while substantive, have not been as dramatic as it could appear. This derives from the notion that the royal family will not dominate the oil sector any more than it has in the past. On the other hand, the name of the game from now on is professionalization, whether in energy or military activities, all under MbS. Hence, while changes will continue to bring young blood and more private involvement in the economy, they will not bring about changes in the oil policy developed by Naimi, and accordingly diminish any hope by inefficient producers that the oil glut will end until an arrangement is found between the Saudis and the other large non-OPEC producers, like Russia.

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